87 1870

NO.

Supreme Court, U.S.
FILED
MAY 7 1988
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1987

ESTATE OF HARLAN O'LEARY, ELOICE B. O'LEARY, JOSEPH LEE O'LEARY, GARY PATRICK O'LEARY AND DONNA DARLENE O'LEARY, EXECUTORS AND ELOICE O'LEARY

Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

TOWNER LEEPER
Attorney for Petitioners
661 Mesa Hills Drive, # 203
El Paso, Texas 79912
(915) 581-8748

A B Letter Service, Inc., 327 Chartres St., New Orleans, La. (504) 581-5555

QUESTIONS PRESENTED

Petitioners purchased large tracts of desert land which were platted and sold. No improvements were made to the land. The contracts of sale called for monthly payments of principal and interest over periods varying from 13 to 20 years. Petitioners used the cost recovery method of reporting their income. Collections of principal and interest were applied against their basis in the land sold and thereafter reported as income. The government conceded that the collection of principal was properly reported but contends that interest is taxable when received under the cost recovery method. The Fifth Circuit has adopted the government's theory. The question presented is:

> Did the Fifth Circuit err in holding that interest payments are currently taxable under the cost recovery method of reporting income, which holding is in direct conflict with decisions in the Second, Fourth and Ninth Circuits which hold that under the cost recovery method all payments are applied against basis until the taxpayer recoups his entire investment in the property sold and only thereafter reported as income?

TABLE OF CONTENTS

Page

Questions Presented.....i
Table of Contents.....ii
Table of Authorities.....iii
Citations to Opinions Below.....1
Statement of the Case.....2
Reasons Why the Writ should be granted.....4
Conclusion and Prayer.....12
Proof of Service.....13

APPENDIX

Appendix A.....A-1
Appendix B.....A-17
Appendix C.....A-19
Appendix D.....A-20

TABLE OF AUTHORITIES

CASES: **Page**

Burnet v. Logan, 238 U.S. 404 (9131).....5,8,9
Commissioner v. Speyer, 77 F.2d 824 (2nd Circuit 1935).....8
Helvering v. Drier, 79 F.2d 501 (2nd Circuit 1935).....8
Helvering v. Winmill, 305 U.S. 79 (1938).....6
Liftin v. Commissioner, 36 T.C. 909 (1961) aff'd 317 F.2d 234 (4th Circuit 1963).....10
Phillips v. Frank, 295 F.2d 629 (9th Circuit 1962).....10
Willhoit v. Commissioner, 308 F.2d 259 (9th Circuit 1962).....10,11

In The
Supreme Court Of The United States
OCTOBER TERM, 1987

ESTATE OF HARLAN O'LEARY, ELOICE B. O'LEARY, JOSEPH LEE O'LEARY, GARY PATRICK O'LEARY AND DONNA DARLENE O'LEARY, EXECUTORS AND ELOICE O'LEARY

Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The petitioners respectfully pray a Writ of Certiorari issue to review the Judgment of the Fifth Circuit Court of Appeals entered on this proceeding on January 7, 1988, and the denial of a Petition for en banc rehearing on February 8, 1988.

CITATIONS TO OPINIONS BELOW

The United States Tax Court, Judge Korner, entered its decision in Tax Court Memo 1986-212. The Fifth Circuit Court of Appeals, Judges Timbers, King and Higginbothom entered its decision in _____F.2d_____ (5th Circuit 1987).

JURISDICTION

Petitioners appeal the judgment of the Fifth Circuit Court of Appeals decided January 7, 1988. Petitioner's petition for en banc rehearing was denied on February 8, 1988. Jurisdiction of this Court is invoked under 28 U.S.C. 1254 and 2101.

STATEMENT OF THE CASE

(a) Course of proceedings and disposition.

Appellants Harlan O'Leary and Eloise O'Leary were husband and wife, residing in El Paso, Texas. They filed timely joint federal income tax returns for 1978 and 1979 with the Internal Revenue Service Center at Austin, Texas. Upon audit the Commissioner of Internal Revenue determined deficiencies in federal income taxes of $49,794.80 for 1978 and $73,084.57 for 1979. Harlan and Eloise O'Leary petitioned the United States Tax Court and a trial was held on May 10, 1985 with the honorable Judge Jules G. Korner presiding. Harlan O'Leary died August 14, 1985. Eloise O'Leary, Joseph Lee O'Leary, Gary Patrick O'Leary and Donna Darlene O'Leary were appointed Joint Independent Executors of his estate and were substituted as petitioner for Harlan O'Leary in this proceeding on November 18, 1985. The Tax Court entered its decision on February 12, 1987 that petitioners were liable for deficiencies in federal income taxes of $70,512.88 for 1978 and $55,356.68 for 1979. Petitioners appealed the Tax Court's decision to the Fifth Circuit Court of Appeals. On January 7, 1988 the Fifth Circuit affirmed per curiam the decision of the Tax Court. The Fifth Circuit subsequently denied petitioners suggestion for an en banc rehearing on February 8, 1988.

(b) Statement of Facts

During the years in issue, and for a number of years prior and subsequent thereto, Harlan O'Leary (petitioner) had been in the business of acquiring unimproved desert land, platting (but not surveying) it and selling lots to the general public under contracts of sales payable in monthly installments, with Harlan retaining the title to the lots until all required payments were made. The land was entirely unimproved, containing no paving, curbing, gutter, electricity, water or sewage, and Harlan made no improvements to the land other than fencing. Possession of a lot was retained by Harlan until all payments due under the outstanding contract of sale were received, and a deed to the property delivered to the buyer.

Prior to 1976, it was not Harlan's ordinary business practice to either state in a contract of sale, or to collect, a "finance charge," although a few exceptions to this general practice occurred. Starting sometime in 1976, however, Harlan began to set out a "finance charge" in the contracts of sale and began to collect the amount of the finance charge in virtually every contract. Such "finance charge," in fact, was interest, and was computed on the remaining principal balance of the purchase obligation, after crediting thereto the portion of each level monthly payment which was attributable to a payment on principal.

For purposes of reporting in their income tax returns, petitioner applied all payments received under the sales contracts, both principal and interest, to reduce their adjusted cost basis in the particular property being sold. When the total of such monthly payments exceeded the cost basis of the property, the excess was reported as income. The only exception to the foregoing statement is that in any year which the buyer canceled his contract, the total amount collected from such buyer, less any amounts

previously reported as income, would be reported as ordinary income from cancellation of the contract.

Upon audit, respondent determined that the "finance charge"was in reality interest income which should be reported in the year collected, whether or not the cost of the property sold had been recovered.

Government's counsel explained the single issue to the Court at trial, "In reporting their income from these contracts, petitioners have applied both principal and interest towards the recovery cost. Respondent has raised no issue with respect to the application of principal collections to cost, but in respondent's view interest must be currently reported." (Tr. 56) (Petitioners Proposed Finding of Fact paragraph 16).

REASONS WHY THE WRIT SHOULD BE GRANTED

Petitioners sold unimproved land under contracts of sale requiring monthly payments over thirteen to twenty year periods. The contracts required monthly payments of both principal and interest. The buyers never took possession. The government has conceded that the petitioners properly reduced their costs with the collection of principal payments. However, the Tax Court determined and the Fifth Circuit erroneously held that the interest collected should not be applied against cost but should be currently reported.

The concept of a cost recovery system of accounting has arisen as a solution to the problem of determining gain on deferred payment sales of property. The difficulty in determining gains on deferred payment sales lies in the fact that Internal Revenue Code Section 1001(b) defines "amount realized"as "the sum of any money received plus the fair market value of the property (other than money)

received." The first difficulty with deferred sales lied in valuing the buyer's obligation to make future payments, especially when the obligation is not evidenced by a negotiable instrument or mortgage but rather is purely contractual. The second difficulty lies in the fact that the cash basis taxpayer is not ordinarily required to report income until he received cash or its equivalent.

Under the cost recovery method of accounting these difficulties are alleviated by allowing the cash basis seller to defer recognition of any gain until he has recouped his investment in the property. This concept was judicially created by the Supreme Court in 1931.

In *Burnet v. Logan*, 283 U.S. 404 (1931), the taxpayer owned 250 shares, and her mother 1180 shares of stock of the Andrews & Hitchcock Iron Company which in turn held a 12% stock interest in the Mahoning Ore & Steel Company. This latter company controlled an iron ore mine by a lease which did not require production of either maximum or minimum tonnage or any definite payments. On March 11, 1916, the Youngstown Sheet and Tube Company purchased all of the outstanding capital stock of Andrews & Hitchcock Company, thus acquiring the 12% stock interest of the ore mined by the Mahoning Company. For the purchase, the Youngstown company paid the stockholders of Andrews & Hitchcock $2,200,000.00 in cash and agreed to pay annually thereafter $.60 for each ton of ore it received. Of the cash paid, the taxpayer received 250/4000 or $137,500.00; and became entitled to the same fraction of any annual payment thereafter made by the purchaser. Taxpayer's mother died in 1917 leaving her one-half of her interest in payments thereafter made. The United States Supreme Court held that the taxpayer was entitled to the return of her investment before recognizing any taxable profit. The Court held that although there had been a completed sale of stock between the parties with the obligation

to pay a specified price per ton being fixed, the cost recovery method of reporting gains was appropriate because the obligation was not the equivilent of cash nor did it have an ascertainable fair market value because the amount of ore to be produced was not determinable. Because the ultimate amount to be realized could not be determined, the taxpayer was allowed to recoup her entire investment before recognizing any income.

Although the cost recovery method of accounting is not provided for a by a specific section of the Internal Revenue Code, it is provided for as an alternative to the installment method of accounting in Treasury Regulation 1.453-6(2) which provides:

> "If the obligations received by the vendor have no fair market value, the payments in cash or other property having fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess."

Treasury Regulation 1.453-6 was enacted in 1958. It was republished in 1960 without any change to Section 1.453-6(2) and was amended in 1967 also without any change being made in Section 1.453-6(2). Because Treasury Regulation 1.453-6(2) has remained unchanged throughout the years it should be deemed to have received congressional approval and thus have the effect of law. *Helvering v. Winmill*, 305 U.S. 79 (1938); *Mertens Law of Federal Income Tax* Section 3.20.

The central problem with the cost recovery system lies in determining *when* the method may be used to report gains from a deferred sales transaction, i.e. when does an obligation received by a vendor so lack an ascertainable fair market value as to justify the seller in recouping his

entire investment before realizing any taxable income. That is, when is the contingency or risk of receiving total payments amounting to a gain great enough to warrant the taxpayer in recovering his basis before reporting income from the transaction. This problem, however, does not exist in the instant case as the Commissioner did not dispute the fact that petitioners were entitled to use the cost recovery method of reporting income. Rather, the Tax Court maintained, and the Fifth Circuit agreed, that petitioners misapplied the cost recovery method when they applied the interest received to reduce their basis in the property sold.

The legal position posed by the government presumes that the obligation to make payments of interest has an ascertainable value which the obligation to make payments of principal does not have. Since both obligations arise from the same contract and the obligation to make principal payments is contingent as to justify deferral of income until recovery of costs, in neither logic nor law is there any basis for distinction for the payment of interest.

Petitioners have been unable to find a case where the courts have taken the position that treatment of interest is different from treatment of principal where taxpayers were entitled to use the cost recovery method of reporting income. The law is quite the contrary.Treasury Regulation 1.453-6(2) makes no distinction between payments relating to principal and payments relating to interest but instead states: "If the *obligation* received by the vendor have no fair market value, the *payments* in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold." The terms "obligations" and "payments" logically refers to the obligation to pay interest as well as the obligation to pay principal. Case law dictates that once it is determined that the principal.

Case law dictates that once it is determined that the cost recovery system is a proper accounting method for reporting income from a deferred sales transaction all future payments under the contract go to reduce the seller's basis in the property until he has recouped his investment regardless of whether the payments relate to principle, interest, or discount and also regardless of whether the legal obligations under the contract have become fixed. The rule of law established by the Fifth Circuit in this case is in direct conflict with the rule of law established in the Second, Fourth and Ninth Circuits.

The Second Circuit in *Helvering v. Drier,* 79 F.2d 501 (1935) and *Commissioner of Internal Revenue v. Speyer,* 77 F.2d 824 (1935) established the rule of law that under the cost recovery method interest income is *not* realized until after full recovery of costs. In *Drier* the taxpayer inherited an estate in Germany consisting of real and personal property. The taxpayer's property was subsequently seized and sold by the German government. After the war the taxpayer filed a claim with the Mixed Claims Commissioner for the loss of her property and in 1928 the Commissioner awarded her $248,000.00 with interest thereon at 5 percent payable by the German government. In 1929 the taxpayer received four payments on the award totaling $169,882.00. The taxpayer kept her books on a cash receipts and disbursements basis. In 1929 she credited all of the payments received on the award against her basis in the converted property even though a portion of each payment indisputably constituted interest. As in the instant case, The Commissioner argued that $54,234.00 of the payments was designated as interest which must be realized as income upon its receipt.

The Second Circuit Court of Appeals agreed with the taxpayer and held under the doctrine of *Burnet v. Logan* that she was entitled to recover her entire basis before realizing interest income. The Court initially discussed the

propriety of the taxpayer's use of the cost recovery method stating, "payment of the remainder of the award is dependent upon circumstances which it is impossible to foretell with reasonable certainty," and "it has been doubtful ever since the award of 1929 was made whether the taxpayer would ever receive payment thereof in full." Then, once the court was satisfied that the cost recovery method was appropriate it stated: "Under these circumstances we agree with the Board that the case is governed by the rule in *Burnet v. Logan* for it cannot be said with truth that the taxpayer has received income in the form of interest or compensation for the use of the property until her receipts shall exceed its capital value. There is no real analogy to the situation of a bond holder who receives payment of interest on the obligation, and must account for it as income, although the total capital has not been returned." Thus, according to the Second Circuit, once it was determined that the cost recovery method was appropriate, the taxpayer was justified in crediting *all* payments against her basis even though a portion of each payment was indisputably designed as interest.

Similarly, in *Speyer* the taxpayer held accounts in German banks which were taken over by the German government. The Mixed Claims Commissioner subsequently entered an award for the taxpayer in the amount of $996,738.00 principal (consisting of interest, dividends, and profits credited to the German account) and $397,775.00 interest from 1920 to 1928 payable by the German government. In 1928 the taxpayer received $485,912.00 as part payment on the award and he treated the entire payment as a restoration of principal. The Commissioner, however, determined that a portion of the payment constituted interest income which was currently reportable. Again, following the doctrine of *Burnet v. Logan* the Second Circuit Court of Appeals held that the taxpayer was entitled to recover his capital investment in

the converted property before realizing taxable interest income due to the speculative nature of future payments. It appears settled in the Second Circuit, therefore, that under the cost recovery method interest income is not realized until the full recovery of costs. This rule of law is in direct conflict with the holding of the Fifth Circuit in the instant case.

The Fourth and Ninth Circuit Courts of Appeals also follow the rule that once the cost recovery method of reporting income is determined to be appropriate, all payments made under the obligation are to be credited to principal until the taxpayer's investment is fully recovered. *Liftin v. Commissioner,* 36 T.C. 909 (1961) *aff'd* 317 F.2d 234 (4th Circuit 1963); *Phillips v. Frank,* 295 F.2d 629 (9th Circuit 1961); *Willhoit v. Commissioner,* 308 F.2d 259 (9th Circuit 1962). In *Liftin* the taxpayer purchased interest bearing notes at substantial discounts from their face value (up to 45%) from various real estate dealers, notes brokers, and builders. The notes were secured by second Deeds of Trust on residential property and provided for monthly payments to be applied first to the payment of interest and the balance to be credited to principal. Each note was in reality a second mortgage given by a purchaser of a home. The Tax Court held and the Fourth Circuit agreed that due to the speculative nature of the investment the taxpayer was not required to report a pro-rata protion of each payment as discount income prior to the recovery of his cost in the notes. The Fourth Circuit held that where there is a doubt whether the contract will be completely carried out the payments should be considered as a return of cost until the full amount thereon has been recovered and no allocation should be made as between such cost and discount income.

Similar reasoning was applied in *Phillips v. Frank,* 295 F.2d 629 (9th Circuit 1961). In *Phillips* a cash basis

taxpayer purchased real estate contracts from sellers of land for an agreed precentage less than the principal amounts due. The District Court found as a fact that the real estate contracts had been purchased by the taxpayer and were thus owned by him. No security for payment was held by the taxpayer for the unpaid balance of the purchase price. The Ninth Circuit Court of Appeals held that payments received under the real estate contracts constituted a return of capital to the taxpayer until he recovered the amount he paid for the contracts, after which time the payments would be taxable discount income. The Court based its decision on the following facts: many of the contracts were highly speculative, there was no evidence that they had a market value in excess of cost, and the only source from which the taxpayer could expect to realize any profit was from payments received after recouping his investment. Similarly, in *Willhoit v. Commissioner,* 308 F.2d 259 (9th Circuit 1962), a cash basis taxpayer purchased home sellers' interest in a number of conditional real estate sales contracts at a discount. The home sellers had become delinquent on construction loans due to the fact that over half of the home purchasers had defaulted on their contracts. Under the contracts the home buyers were legally bound to pay a fixed sum in monthly installment payments consisting of interest and principal. The Ninth Circuit Court of Appeals held that all receipts under the real estate contracts constituted return of capital to the cash basis taxpayer until he recovered his cost in the contracts despite the fact that the purchasers were unconditionally obligated to pay. The Ninth Circuit emphasized that many of the contracts were speculative and had a history of defaults and therefore the chances of the taxpayer realizing a profit were quite slim. Therefore no apportionment between principal and discount income was necessary. Consequently, it is apparent that in both the Fourth and Ninth Circuits, once it is determined that the cost recovery method is appropriate, *all* payments received are to be be

applied against basis until the taxpayers investment is fully recouped.

In light of the foregoing background of the judicial development of the use and application of the cost recovery method and the Treasury Regulations long standing adoption of same, as applied to the undisputed facts in the instant case, petitioners respectfully submit that the Fifth Circuit's position is simply erroneous as a matter of law and is in direct conflict with the law as established in the Second, Fourth and Ninth Circuits. This direct conflict between the circuits needs to be resolved by the Supreme Court due to nation wide use of the cost recovery method by taxpayers and the instant case could well serve as a vehicle for the Court to express the proper application of the cost recovery method as it relates to the receipt of interest payments.

CONCLUSION AND PRAYER

Because of the importance and broad application of this issue in Federal tax cases, the petitioners pray that this Court grant a Petition of Certiorari to the United States Supreme Court.

Respectfully submitted,

Towner Leeper
Counsel for Petitioners
661 Mesa Hills Drive, # 203
El Paso, Texas 79912
(915) 581-8748

PROOF OF SERVICE

The undersigned attorney of record for Petitioners hereby certified as follows:

(A) That I, Towner Leeper, am a member of the bar of the United States Supreme Court, and that I have duly served all parties required by the rules of said Court to be served with the foregoing Petition for Certiorari, as hereinafter shown.

(B) That the names and addresses of the attorneys of record for the adverse party are as follows:

The Honorable Judge Charles Fried
Solicitor General of the United States, Department of Justice
Washington, D.C. 20530

The Honorable William S. Rose
Assistant Attorney General, Department of Justice
10th Street & Constitution Ave. N.W.
Washington, D.C. 20530

Michael L. Paup
Ann Belanger Duray
Richard J. Drilcoll
Attorneys
Tax Division, Department of Justice, Post Office Box 502
Washington, D.C. 20044

(C) That on this day, I served three printed copies of the foregoing Petitioner for Certiorari on the said Charles Fried, William S. Rose, Michael L. Paup, Ann Belanger Durney, and Richard Driscoll by deposition same in the United States Mail First Class properly addressed to their said address.

Executed this 6th day of May, 1988

_____

Towner Leeper

APPENDIX A

T. C. Memo. 1986-212

UNITED STATES TAX COURT

ESTATE OF HARLAN O'LEARY, ELOICE B. O'LEARY, JOSEPH LEE O'LEARY, GARY PATRICK O'LEARY AND DONNA DARLENE O'LEARY, EXECUTORS AND ELOICE O'LEARY, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 6136-84. Filed May 27, 1986.

Towner Leeper, for the petitioners.
Marion S. Friedman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KORNER, *Judge:* For the calendar years 1978 and 1979, respondent determined deficiencies in the joint income tax liability of Harlan O'Leary and Eloise O'Leary in the respective amounts of $49,794.80 and $73,084.57. After concessions, the issues which we must resolve are: (1) Whether, under the so-called cost-recovery method of reporting gain from the sale of property, petitioners are entitled to charge both periodic payments of interest and principal against their unrecovered cost basis, deferring any reporting of income until all such cost basis has been recovered; and (2) Whether, if respondent is sustained on this issue, adjustments to petitioners' income in the years before us should be made under the provisions of section

SERVED: MAY 27 1986

481,[1] and the amount thereof.

Some of the facts herein were stipulated, and such stipulations, together with accompanying exhibits, are incorporated herein and made a part hereof.

FINDINGS OF FACT

Harlan O'Leary and Eloise O'Leary were husband and wife and filed joint income tax returns on the cash basis for the calendar years 1978 and 1979. At the time the petition herein was filed, they were residents of El Paso, Texas. Subsequent to trial herein, petitioner Harlan O'Leary (hereinafter "Harlan") died, and his estate, through his duly qualified executors, was substituted as a party petitioner.

During the years in issue, and for a number of years prior and subsequent thereto, Harlan had been in the business of acquiring unimproved desert land, platting (but not surveying) it and selling lots to the general public under contracts of sale payable in monthly installments, with Harlan retaining title to the lots until all required payments were made. The land was entirely unimproved, containing no paving, curbing, gutters, electricity, water or sewerage, and Harlan made no improvements to the land other than fencing. Possession of a lot was retained by Harlan until all payments due under the outstanding contract of sale were received, and a deed to the property delivered to the buyer.

Prior to 1976, it was not Harlan's ordinary business practice to either state in a contract of sale, or to collect, a "finance charge," although a few exceptions to this general

---

[1] All statutory references are to the Internal Revenue Code of 1954, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

practice occurred. Starting sometime in 1976, however, Harlan began to set out a "finance charge" in the contracts of sale and began to collect the amount of the finance charge in virtually every contract. Such "finance charge," in fact, was interest, and was computed on the remaining principal balance of the purchase obligation, after crediting thereto the portion of each level monthly payment which was attributable to a payment on principal.

All the sales contracts for individual lots entered into by Harlan and the respective purchasers contained the following, inter alia:

a. A provision that failure to comply with the payment provisions would, at the option of the seller, mature the obligation or cancel the contract. In the event of cancellation by the seller, any sum of money previously paid by the purchaser would be considered as rent and liquidated damages.

b. Each contract contained the following provision:

> The "TOTAL PAYMENTS" shown is payable in ____consecutive monthly installments of $____ each, beginning on ____, and a like installment on the __ day of each month thereafter until fully paid, principal and interest. Monthly payments include principal and interest. [The appropriate number of monthly payments, the dollar amount, and the effective dates were inserted in each contract.]

c. All the sales contracts were payable over a period of years, varying from 13 to 20.

d. Each sale contract form provided for the

disclosure of the following information:

Cash Price	$_____
Down Payment	$_____
Amount Financed	$_____
FINANCE CHARGE	$_____
Total of Payments	_____
Deferred Payments Price	$_____
ANNUAL PERCENTAGE RATE	_____

Nearly all of the sales contracts involved in this case were completely filled out with respect to the above information with respect to the terms of the individual sale. A few of the sales contracts contained no entries on the lines for "FINANCE CHARGE" and/or "Deferred Payments Price." All contracts in issue in this case, however, contained entries on the lines "Amount Financed" and "ANNUAL PERCENTAGE RATE," even where other items of information were missing, and in all cases, interest was actually charged on the deferred portion of the payment price at an annual rate of 5 percent or more.

Actual collection of the individual purchaser's monthly payment was performed by the real estate collection department at various banks. When the collecting bank received a purchaser's payment, a collection receipt was prepared which showed, among other things, the payment date, payment amount, amount applied to principal, amount applied to interest, amounts applied to various bank charges and finally, the net amount deposited in Harlan's bank account.

Ledger cards were maintained in Harlan's office for each sale contract, showing the name and address of the purchaser, the date of the contract, the amount of the monthly payment, and the applicable percentage rate. Based upon information received from the collecting bank,

Harlan's office made entries on its ledger cards, showing the amount of interest and the amount or principal in each level monthly payment, with the principal portion *only* being credited to the remaining principal balance on the purchase contract. Said principal balance was shown as decreasing monthly, as the principal portion of each monthly payment was applied to it. As the remaining parincipal balance on the purchase contract decreased, the amount of each monthly payment attributable to interest also decreased, and the amount attributable to principal payments correspondingly increased.

For purposes of reporting in their income tax returns, petitioners applied all payments received under the sales contracts, both principal and interest, to reduce their adjusted cost basis in the particular property being sold. When the total of such monthly payments exceeded the cost basis of the property, the excess was reported as income. The only exception to the foregoing statement is that in any year in which the buyer[2] canceled his contract, the total amount collected from such buyer, less any amounts previously reported as income, would be reported as ordinary income from cancellation of the contract.

Upon audit, respondent determined that the "Finance Charge" was in reality interest income which should be reported in the year collected, whether or not the cost of the property sold had been recovered.

The following facts are found as material and relevant with respect to petitioners' income from the "finance charges," i.e. interest, received by them in 1978 and 1979 on account of the land sale contracts here in issue:

---

[2] So stipulated by the parties. Consistent with the terms of the contract, however, "buyer" should probably be "seller."

	1978	1979
Total "Finance Charges," i.e. interest, collected	$134,874.61	$129,543.64
"Finance Charges," i.e. interest, already reported by petitioners from canceled contracts	9,466.50	16,896.35
"Finance Charges," i.e. interest, already reported by petitioners with respect to contracts where recovery exceeded basis under petitioners' method of accounting, and principal which was reported by petitioners as in excess of basis but which is not in excess of basis if 1978 and 1979 "Finance Charges" are reported in the year of receipt in lieu of being applied to cost basis of property	3,088.09	11,545.34

Prior to 1978, petitioners omitted from income interest in the amount of $76,514.79, which was instead applied to reduce their cost basis in land sales contracts. Under petitioners' method of accounting, the unrecovered costs in the land contracts were $718,218.84 on December 31, 1977. If said omitted interest income were not applied to reduce costs basis, said unrecovered cost basis at December 31, 1977, would be $794,733.63.

The method of accounting employed by petitioners in their 1978 and 1979 tax returns did not clearly reflect their income.

OPINION

I

In determining the amount of gain or loss from the sale of property, the general rule is that such amount shall be determined by a comparison of the "amount realized"from the sale with the taxpayers' adjusted basis, sec. 1001(a), and the "amount realized" from the sale "shall be the sum of any money received plus the fair market value of the property (other than money) received." Sec. 1001(b). In addition to this general rule, however, section 1001(d) provides as follows:

> (d) Installment Sales.--Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

Expanding further upon the alternative provided by section 1001(d) to the general rule of sections 1001(a) and (b), -- that is, the permissible use of the installment method of reporting -- respondent's regulations provide:

> Other accounting methods. If the vendor chooses as a matter of consistent practice to return the income from installment sales on an accrual method or on the cash receipts and disbursements method, such a course is permissible. [Sec. 1.453-1(e), Income Tax Regs.]

As a subvariant on the permissible way to report sales of property on the installment basis, respondent's regulations further provide:

> (a) Value of obligations. (1) In transactions included in paragraph (b)(2) of §1.453-4, that is, sales of real property involving deferred payments * * *, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. * * *
>
> (2) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value. [Sec. 1.453-6(a), Income Tax Regs.]

The last-quoted regulation is an embodiment of the principle enunciated by the Supreme Court many years ago in the case of *Burnet v. Logan*, 283 U.S. 404 (1931), where the Court held that in a sale of property, where the purchaser's obligation was neither cash nor capable of being valued, the seller was entitled to recover his cost basis from payments as received, before being required to report a gain on the transaction, i.e., the "open transaction" doctrine. This method of accounting for tax purposes, which has come to be known as the cost-recovery or deferred-payment method, has been applied in later cases, see *Ennis v. Commissioner*, 17 T.C. 465 (1951). Later cases, however, have made it clear that even though the purchaser's obligation received by the seller may not be in the form of a negotiable note or other type of property which is freely

traded and can be valued at its full face value, nevertheless if a fair market value for such obligation can be established, it must be considered as the equivalent of cash received to the extent thereof, so that use of the cost-recovery method is not permitted, and gain or loss on the sale must be reported to the extent of the fair market value of the obligation received. See *Warren Jones Co. v. Commissioner,* 60 T.C. 663 (1973), revd. 524 F.2d 788, 793-794 (9th Cir. 1975); *Heller Trust v. Commissioner,* T.C. Memo. 1965-302, T.C. Memo. 1966-121, revd. on other issues 382 F.2d 675 (9th Cir. 1967).

In the instant case, respondent concedes that petitioners were entitled to use the cost-recovery method in accounting for gain or loss from the executory sales contracts which Harlan entered into for the sale of his desert lots. Respondent, however, contends that the cost-recovery method applies only with respect to periodic payments of principal received, and that the interest portion of each periodic payment must be currently reported as ordinary interest income. Petitioners, to the contrary, contend that the cost-recovery method entitles them to apply both the interest and principal portions of each monthly payment, as received, against their remaining cost basis, and that they are not obliged to report any gain from the sale of the desert lots involved here until such time as their remaining cost bases are exhausted from the application of principal and interest payments. We agree with respondent.

Petitioners cite a number of cases holding that the holder of a debt obligation of unascertainable value is entitled to apply all his payments, both principal and interest, against his cost basis until such cost basis is fully recovered, before reporting any income: *Willhoit v. Commissioner,* 308 F.2d 259 (9th Cir. 1962), revg. T.C. Memo. 1958-207; *Liftin v. Commissioner,* 36 T.C. 909 (1961), affd. 317 F.2d 234 (4th Cir. 1963); *Underhill v. Commissioner,*

45 T.C. 489 (1966); *Phillips v. Frank,* 295 F.2d 629 (9th Cir. 1961). All such cases, however, are distinguishable from the case at bar. In each of them, the taxpayer who was the holder of the debt obligation was not the original seller of the property, but had purchased the installment obligation from the original creditor at a discout, and as a speculative investment. He accordingly had a cost basis in the debt obligation itself, in an amount equal to the price which he had paid for it. Since the value of the obligation was speculative, and it could not be determined with certainty whether all the stated obligations would be paid, it was held in each of those cases that the taxpayer/purchaser was entitled to recover his entire cost basis in the purchased obligation, whether through interest or principal payments, before being required to report any imcome. In this situation, the distinction between principal and interest payments in the hands of such third party purchaser was irrelevant.

In the case at bar, however, the situation is entirely different. Here, petitioners had no cost basis in the interest payments which they received, and such payments were fully reportable in the year of receipt. They did have a cost basis in the properties which were being sold, and under the cost-recovery method of accounting, they were entitled to apply the principal portions of each monthly payment against those various cost bases, until they were fully absorbed.

Under their alleged method of accounting, petitioners unilaterally attempted to convert interest payments into principal payments, crediting the full amount of each monthly payment against their remaining cost bases, and thus deferring the reporting of any income until such cost bases were fully recovered. This they may not do. The contracts of sale which Harlan entered into with his various purchasers made it perfectly clear that

each monthly periodic payment was composed of two elements -- principal and interest -- and that only the principal portion of each monthly payment was to be credited against the buyer's remaining obligation under the purchase contract. Both the bank collection agents' accounts, as well as the internal accounts maintained by Harlan, were consistent with this basis.

Where periodic payments consisting of both principal and interest elements are received, the general rule, known as the "United States Rule," is that such periodic payments are applied first to interest, with any remaining amount being applied to principal, absent any agreement of the parties to the contrary, *Story v. Livingston,* 38 U.S. (13 Pet.) 359, 370-374 (1839); *Acker v. Provident National Bank,* 373 F.Supp. 56, 69 (E.D. Pa. 1974), revd. on another issue 512 F.2d 729 (3rd Cir. 1975); *Agostini v. Colonial Trust Co.,* 28 Del. Ch. 30, 36 A.2d 33, 39 (1944). It is clearly the rule of law in Texas, where these contracts were entered into. *Bradford v. Thompson,* 460 S.W. 2d 932, 938 (Tex. Civ. App. 1970), affd. in part and revd. in part on other grounds 470 S.W. 2d 633 (Tex. 1971), cert. denied 405 U.S. 955 (1970); *Straus v. Brooks,* 126 S.W. 2d 542 (Tex. Civ. App. 1939), revd. on other grounds 136 Tex. 141, 148 S.W. 2d 393 (Tex. Comm. App. 1941). The same rule has been applied in this Court. *Maxine Development Co., Inc. v. Commissioner,* T.C. Memo. 1963-300. It is clear in this case that the parties to the deferred sale contracts intended the general rule regarding application of principal and interest payments to apply. "That which is in fact interest cannot be made principal simply by calling it such." *J.I. Case Co. v. Laubhan,* 64 S.W. 2d 1079, 1080 (Tex. Civ. App. 1933).

In *Rodney v. Commissioner,* 53 T.C. 287 (1969), the taxpayer sold property under an interest bearing contract calling for fixed monthly payments. He also made loans evidenced by interest bearing notes with fixed monthly

payments. Consistent with the terms of the obligations, taxpayer's collection agents allocated each payment between principal and interest. The taxpayer claimed that, because of the speculative nature of the obligations received, he was entitled to recover his full cost bases therein through the monthly payments of principal *and* interest before being required to report any gain from the transactions. Respondent, while apparently not contesting the taxpayer's right to recover his cost bases through *principal* payments as received -- the cost-recovery method -- contended that the *interest* portion of each monthly payment was fully reportable as received.

In sustaining respondent on this issue, we said:

> A debtor and creditor have the right to earmark the amount of a deferred payment between principal and interest and where such an allocation is made the interest income of the creditor is the amount so agreed upon. *Huntington-Redondo Co.*, 36 B.T.A. 116 (1937). Where there is no allocation made by the parties the general rule is that the amount shall first be applied to liquidation of the interest due before any part is applied to the principal. *Helvering v. Drier*, 79 F.2d 501, 503 (C.A. 4, 1935), affirming a Memorandum Opinion of this Court. The conditional-sales contract specifically provided for interest. The escrow statement for escrow No. 15194 submitted by the Spokane and Eastern Branch of the Seattle First National Bank indicates that as each payment was made the bank, acting as agent for the parties, allocated such payment between interest and principal.
>
> The parties also agreed to the 6 1/2-percent interest rate on the notes involved in the loan transactions. Each monthly payment, by the very

> terms of the notes, included the interest due at the time the installment was paid. The collecting agent also made allocations between principal and interest as to each payment received.
>
> We therefore hold that petitioner is not entitled to recover his entire basis in the property sold under the October contract or to recover his capital under the notes before allocating any of the payments received pursuant thereto to interest but must instead allocate each payment as received between interest and principal, with interest being computed at 6 1/2 percent per year. (53 T.C. at 312-313.]

We likewise hold here that the cost-recovery method, with respect to taxpayers such as the instant petitioners, does not include the right to convert interest payments into principal payments; that the method of accounting used by petitioners did not clearly reflect their income; and that respondent was therefore authorized to change petitioners' method of accounting to a proper cost-recovery method, and to require that periodic payments of interest under the deferred sale contracts be currently reported as income. Sec. 446(b).

II

The parties have stipulated that if we should hold for respondent on the first issue herein, which we have, then it should be considered that respondent's adjustment on this issue constituted a change of accounting method within the meaning of section 481, and that the necessary recomputation of petitioners' income and tax should be done under the provisions anad subject ot the limitations of that section. Although such stipulation of the parties relates to matters of law and not to matters of fact, and is therefore not binding on the Court, *King v. United States*,

641 F.2d 253 (5th Cir. 1981), nevertheless we agree that what respondent did here amounts to a change of accounting method, see section 1.446-1(e)(2)(ii), Income Tax Regs., and accordingly the provisions of section 481 are applicable. See *Electric & Neon, Inc. v. Commissioner,* 56 T.C. 1324, 1336-1337 (1971), affd. without opinion 496 F.2d 876 (5th Cir. 1974); *Graff Chevrolet Company v. Campbell,* 343 F.2d 568 (5th Cir. 1965); *Peoples Bank & Trust Co. v. Commissioner,* 50 T.C. 750 (1968), affd. 415 F.2d 1341 (7th Cir. 1969). We must now consider how such provisions should be applied.

Section 481(a) provides as follows:

> (a) General Rule.--In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")--
>
> (1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then
>
> (2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

The above subsection applies to any change in method of accounting where the year of the change is a taxable year beginning after December 31, 1953, and ending after

August 16, 1954, and thus applies to all relevant years herein. Pub. L. 85-866, sec. 29(a), 72 Stat. 1606, 1626.

It is clear that the recomputation of petitioners' income for the years 1978 and 1979 -- the years before us -- must be done under the cost-recovery method of accounting, as determined by respondent, which is different from the method used by petitioners for their preceding years, beginning with 1976, when Harlan first began to charge interest on his deferred sales contracts. The provisions of section 481(a)(1) are thus satisfied. Under the provisions of section 481(a)(2), there must therefore "be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, * * * ."

In the context of this case, the adjustments required by section 481(a)(2) are the following:

a) The interest income actually collected in years prior to 1978, but not reported in those years, should be brought into income in 1978. The parties have stipulated that such amount was $76,514.79.

b) The same amount, which petitioners used to reduce their cost bases prior to 1978, should be restored to basis at December 31, 1977. The parties have stipulated that such adjustment would produce a total remaining cost basis of $794,733.63.

c) To the extent that petitioners' improper method of charging interest against cost basis caused them to report gain from sales of lots *prior* to 1978, such improperly reported gains should be subtracted from 1978 income. All such adjustments are to be made to petitioners' income for 1978, the first year in which the proper cost-recovery method is used, which is the "year of the change" under

section 481. *Electric & Neon, Inc. v. Commissioner, supra.*

Such adjustments having been made, petitioners' income for 1978 and 1979 is to be recomputed under the cost-recovery method, including the following:

d) All interest collected in each respective year is to be included in income for such year. The parties have stipulated that such amounts are $134,874.61 for 1978 and $129,543.64 for 1979.

e) Gain from the sale of lots in 1978 and 1979 is to be recomputed under the proper cost-recovery basis by reducing the respective cost bases, as corrected to December 31, 1977, under section 481(a)(2), only by the periodic payments of principal received in each year with respect to each lot, with no gain to be reported until each such basis is exhausted.

In recomputing the tax hereunder, the limitations of section 481(b)(1)(2) and/or (3) shall be applied, as appropriate.

Decision will be entered under Rule 155.

APPENDIX B

UNITED STATES TAX COURT

ESTATE OF HARLAN O'LEARY, ELOICE B. O'LEARY, JOSEPH LEE O'LEARY, GARY PATRICK O'LEARY, AND DONNA DARLENE O'LEARY, EXECUTORS, AND ELOICE O'LEARY.	)	
Petitioners.	)	
v.	)	Docket No. 6136-84
COMMISSIONER OF INTERNAL REVENUE.	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed May 27, 1986, and incorporating herein the facts recited in the respondent's computation as the finding of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioners for the taxable years 1978 and 1979 in the amounts of $70,512.88 and $55,356.68, respectively.

/s/ illigable
Judge.

Entered:
FEB 12 1987

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

/s/ Towner Leeper
TOWNER LEEPER
Counsel for Petitioners
661 Mesa Hills Drive
El Paso, Texas 79912
Tel. No. 915/581-8748

WILLIAM F. NELSON
Chief Counsel
Internal Revenue Service

By: /s/ Bernard B. Nelson
BERNARD B. NELSON
Assistant District Counsel
10850 Richmond Avenue
Suite 350
Houston, Texas 77042
Tel. No. 713/954-1200

1/29/87

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

---

no. 87-4197

ESTATE OF HARLAN O'LEARY, ELOICE B. O'LEARY, JOSEPH LEE O'LEARY, GARY PATRICK O'LEARY and DONNA DARLENE O'LEARY, Executors, and ELOICE O'LEARY,

Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

- - - - -

Appeal from the Decision of the United States Tax Court

- - - - -

(January 7, 1988)

Before TIMBERS*, KING, and HIGGINBOTHAM, Circuit Judges.

PER CURIAM: AFFIRMED. See Local Rule 47.6.

*Circuit Judge of the Second Circuit, sitting by designation.

APPENDIX D

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 87-4197

Filed
FEB 8 1988

ESTATE OF HARLAN O'LEARY, ELOICE B. O'LEARY, JOSEPH LEE O'LEARY,GARY PATRICK O'LEARY AND DONNA DARLENE O'LEARY EXECUTORS and ELOICE O'LEARY,

Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondents-Appellee.

Appeal from the Decision of the United States Tax Court

ON SUGGESTION FOR REHEARING EN BANC

(Opinion 1/07/88, 5 Cir., 198__, __F.2d__)

(February 8, 1988)

Before TIMBERS*, KING and HIGGINBOTHAM, Circuit Judges.

*Circuit Judge of the Second Circuit, sitting by designation.

PER CURIAM:

(X) Treating the suggestion for rehearing en banc as a petition for panel rehearing, it is ordered that the petition for panel rehearing is DENIED. No member of the panel nor Judge in regular active service of this Court having requested that the Court be polled on rehearing en banc (Federal Rules of Appellate Procedure and Local Rule 35), the suggestion for Rehearing En Banc is DENIED.

( ) Treating the suggestion for rehearing en banc as a petition for panel rehearing, the petition for panel rehearing is DENIED. The judges in regular active service of this Court having been polled at the request of one of said judges and a majority of said judges not having voted in favor of it (Federal Rules of Appellate Procedure and Local Rule 35), the suggestion for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

/s/ P. S. Higgibotham

United States Circuit Judge REHG-8